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FRS 102

The 46 Most Pressing **Lease Accounting** Questions from Your Peers

Get the technical clarity you need. We have captured the most pressing concerns from our recent UK webinars and paired them with practical solutions from our accounting experts. Your roadmap to confident reporting starts here.

The Financial Reporting Council's (FRC) updates to FRS 102 mark one of the most significant shifts in UK and Irish accounting in decades. By aligning lease accounting closely with IFRS 16, the new standard effectively removes the distinction between operating and finance leases for lessees.

For Controllers and Finance Directors, this mandates a fundamental change in reporting: bringing nearly every lease—from commercial property to vehicle fleets—onto the balance sheet.

While the core concept is straightforward—recognise a Right-of-Use (ROU) asset and a corresponding liability—the practical application is anything but. The complexity lies in the nuances:

- Identifying embedded leases within broader service contracts
- Calculating the correct discount rates
- Handling specific UK complexities like salary sacrifice schemes
- Managing ongoing lease modifications and remeasurements

To help you navigate this transition with confidence, we have compiled the most pressing questions asked by UK accounting professionals during our recent FinQuery webinars. Our team of technical accountants has provided clear, practical answers to help you move from uncertainty to confident compliance.

BLOG POST

FRS 102 Embedded Leases: Your Preparedness Guide

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Scope: General Applicability

The first hurdle in adopting the updated FRS 102 for lease accounting is strictly defining the perimeter of your lease portfolio. For lessees, the comfortable distinction between operating and finance leases has been removed, replaced by a single model that demands balance sheet recognition for nearly all contract-driven obligations.

This section addresses the foundational questions of scope—clarifying which entities must comply, how to handle complex intra-group arrangements, and where the line is drawn between a lease and a service contract.

1 Does the transition to FRS 102 effectively eliminate the classification of "operating leases" for lessees, requiring all leases to be recognised on the balance sheet?

Yes, for the most part. Under the updated FRS 102, the distinction between operating and finance leases is removed for lessees. You must recognise a Right-of-Use (ROU) asset and a Lease Liability for all leases. The only exceptions are if you proactively elect to use the short-term lease exemption (12 months or less) or the low-value asset exemption (e.g., small IT equipment, office furniture).

2 Does the updated FRS 102 lease accounting standard apply to entities classified as "small" or "micro" under the Companies Act, or are they exempt?

"Small" entities applying FRS 102 Section 1A are in scope; they must recognise leases on the balance sheet just like larger entities. However, "Micro" entities applying FRS 105 are exempt. FRS 105 is based on a simplified historical cost framework, so micro-entities will continue to expense lease payments through the P&L as they are incurred (similar to the old operating lease model).

3 Are intra-group rentals of property, plant, or vehicles considered leases within the scope of FRS 102, requiring balance sheet recognition by the lessee subsidiary?

Yes. Intra-group arrangements are in scope if they meet the definition of a lease (an identifiable asset where the user controls the use). Even if there is no formal written contract, if the subsidiary has exclusive use of the asset and pays for it (even via intercompany account), a lease liability and ROU asset must be recognised in the subsidiary's individual financial statements.

4 Does a contract fail to meet the definition of a lease under FRS 102 (specifically regarding the "right to control" and "substantially all the capacity") if the lessee only has access to 50% or less of the asset's capacity?

Likely yes, it would fail to be a lease. To be an "identified asset," the lessee must typically have the right to obtain substantially all (implied >90%) of the economic benefits from the use of the asset. If you only have rights to 50% of a distinct asset's capacity (e.g., 50% of the capacity of a fibre optic cable or a pipeline), and the portion is not physically distinct, you do not "control" the asset. This would likely be accounted for as a service contract, not a lease.

5 If an entity already holds property as an "investment property" measured at fair value, does the new FRS 102 lease standard still apply to the underlying lease agreements or valuation method?

If you are the Lessor (you own the property and rent it out), you continue to apply the specific investment property accounting (Fair Value through P&L) under Section 16; the new lease standard does not change the valuation of the investment property itself.

If you are the Lessee (you rent a property and then sub-let it as investment property), you must recognise the head lease as an ROU asset. You then measure that ROU asset at Fair Value (Section 16) rather than Cost (Section 20) if you classify it as investment property.

BLOG POST

FRS 102 Leases Explained: Summary, Examples, Journal Entries, and Disclosures

Scope: Low-Value & Short-Term Exemptions

While the updated FRS 102 standard mandates comprehensive balance sheet recognition, it provides strategic relief for specific asset categories. Understanding these recognition exemptions—specifically for short-term leases and low-value assets—is critical for streamlining your compliance workload.

By correctly applying these accounting policy choices, you can prevent your balance sheet from becoming overburdened with immaterial items, such as office furniture or IT peripherals. This section clarifies the strict criteria for these exemptions and defines the boundary between a lease and a service contract.

1 **Does applying the 'short-term' or 'low-value' lease exemptions in FRS 102 require recognising the lease on the balance sheet, or is the requirement limited to note disclosures regarding future commitments?**

It is limited to note disclosures. If you elect these exemptions, you do not recognise a Right-of-Use asset or Lease Liability on the balance sheet. Instead, you recognise the lease payments as an expense in the P&L on a straight-line basis over the lease term (similar to the old operating lease model). You must disclose the expense incurred and the future lease commitments in the notes.

2 **What is the specific maximum lease term duration that qualifies as a 'short-term lease' under FRS 102 for the purpose of claiming an exemption from balance sheet recognition?**

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less. **Crucial Note:** This includes any period covered by an option to extend the lease if the lessee is reasonably certain to exercise that option. A lease with a 6-month initial term and a "likely to be exercised" 12-month extension is **not** a short-term lease.

3 **What is the monetary threshold or definition for a 'low-value asset' under FRS 102, and would assets like printers costing £10,000 or coffee machines costing £20,000 qualify for this exemption?**

The standard does not set a hard currency cap, but the basis for conclusions (aligned with IFRS 16) suggests a benchmark of approximately \$5,000 (approx. £4,000) when the asset is new. Therefore, a £10,000 printer or £20,000 coffee machine would not qualify as low value and must be capitalised. "Low value" typically applies to tablets, small personal computers, telephones, and small office furniture.

4 **Are leases of intangible assets, such as software application licences, within the scope of the FRS 102 lease accounting standard, or are they excluded?**

They are generally excluded. Leases of intangible assets (like software licences) are outside the scope of the Lease section (Section 20). Instead, they are accounted for under Section 18 (Intangible Assets other than Goodwill). Most software subscriptions are treated as service contracts or intangible assets, not leases.

5 **Does a contract for the supply of uniforms, where the supplier cleans them and has the substantive right to substitute the items with different physical pieces, meet the definition of a lease (specifically regarding the 'identified asset' criteria) under FRS 102?**

No. This arrangement fails the "Identified Asset" test. If the supplier has the substantive right to substitute the asset (i.e., they can swap the uniforms for others at any time for cleaning/repair and economically benefit from doing so), the customer does not control a specific asset. This is accounted for as a service contract, and the costs are expensed to the P&L as incurred.

Scope: Vehicles & Salary Sacrifice

For many UK organisations, vehicle fleets represent the second largest leasing obligation after real estate. However, the updated FRS 102 introduces new complexity to these common assets, particularly regarding the treatment of Electric Vehicle (EV) salary sacrifice schemes and shared "pool" vehicles.

The critical task for Finance Directors is distinguishing between operational usage and legal liability. It is essential to identify the contract holder to ensure liabilities are correctly recognised on the balance sheet, rather than incorrectly netted off against payroll deductions.

1 Are company 'pool cars' subject to balance sheet recognition as Right-of-Use assets and lease liabilities under FRS 102, or are they treated differently from other vehicle leases?

Yes, they are subject to recognition. "Pool cars" are treated exactly the same as any other leased asset. If the company enters into a contract to rent the vehicle for more than 12 months, the company controls the asset. Therefore, you must recognise a Right-of-Use (ROU) asset and a Lease Liability on the balance sheet. There is no specific exemption for pool vehicles.

2 How are Electric Vehicle (EV) salary sacrifice schemes accounted for by the employer under FRS 102—specifically, does the employer (who holds the head lease) need to recognise the full lease liability on their balance sheet?

Yes. In a typical salary sacrifice scheme, the employer is the lessee who signs the contract with the leasing company (e.g., Octopus, Zenith). The employer has the primary obligation to pay the lessor.

- » Balance Sheet: The employer must recognise the full Lease Liability and ROU Asset.
- » P&L: The salary sacrifice deduction is treated as a separate payroll/income arrangement with the employee and does not net off the liability to the lessor.

3 Does the 'materiality' of the net cost (lease expense less employee salary sacrifice deduction) affect the requirement to recognise the gross lease liability for salary sacrifice vehicles under FRS 102?

No. Materiality is assessed on the Gross balances (the Asset and Liability), not the net P&L impact. While the P&L impact might be neutral (Lease Expense vs. Salary Sacrifice Income), the Balance Sheet gross-up is likely material. Adding £1m of vehicle liabilities and £1m of assets significantly changes your gearing and return on asset ratios, which is material information for users of the accounts. You cannot "net" the asset and liability.

4 If a vehicle is provided to an employee where the employee is the primary signatory and legally liable for the contract (and the company merely facilitates payment via payroll), does the company recognise a lease liability under FRS 102?

No. If the employee is the contract holder and legally liable for the payments, the lease belongs to the employee, not the company. The company is acting merely as an agent facilitating payment.

- » Accounting: The company recognises no Lease Liability or ROU Asset. The payments made on behalf of the employee are simple P&L payroll/expense transactions.

Lease Term: Break Clauses & Rolling Contracts

Under FRS 102, the 'lease term' is rarely just the date printed on the final page of your contract. Instead, it represents the period you are reasonably certain to remain in possession of the asset, requiring finance teams to look beyond the legal text and assess the economic reality of their operations.

This distinction is critical because the length of the lease term is the primary multiplier for your balance sheet liability. Whether evaluating a break clause in an office lease or determining the horizon of a rolling monthly contract, you must weigh economic incentives—such as significant leasehold improvements—against the flexibility to leave. This section clarifies how to document these judgements defensibly at the transition date.

1 How is the 'lease term' determined under FRS 102 when a contract contains a lessee break option (an option to terminate the lease early)?

The lease term is the non-cancellable period minus the time period included in an option to terminate if the lessee is reasonably certain to exercise the option.

- If you are reasonably certain you will stay past the break, you calculate the liability to the lease end date.
- If you are not reasonably certain (i.e., you probably will leave), you calculate only to the break date.

2 What criteria are used to decide whether to calculate the lease liability up to the break date or the full contractual end date (specifically regarding the 'reasonably certain' threshold)?

You must assess economic incentives. You may be "reasonably certain" to stay (and ignore the break) if:

- You have spent significant money on Leasehold Improvements.
- The rent is significantly below market rates (a "bargain").
- The location is critical to your operations.
- Moving would incur significant disruption costs.

3 For building leases, should the lease liability be measured based on the non-cancellable period up to the first break option, or the full duration of the lease?

It depends on the assessment in the previous question.

- **Example:** A 10-year lease with a break at year 5.
- **Scenario A:** You just installed a £500k custom fit-out. You are reasonably certain to stay. Lease Term = 10 years.
- **Scenario B:** It is a generic office, and you are unsure of your long-term needs. You are not reasonably certain to stay. Lease Term = 5 years.

4 How is the lease term determined for 'rolling' or open-ended contracts with no specific end date (e.g., monthly rolling leases) under FRS 102?

Technically, the enforceable period is often just the notice period (e.g., 1 or 3 months). However, FRS 102 looks at substance.

- If the contract rolls monthly but you have significant economic incentives to stay (e.g., essential machinery installed), the lease term is the period for which you are reasonably certain to extend.
- If there are no significant penalties or incentives to stay, the lease term is just the notice period. In this case, it usually qualifies as a Short-Term Lease and is exempt from the balance sheet.

5 Is the impact of a future break clause recognised at the initial measurement date of the lease liability, or is it ignored until the break option is actually exercised?

It is recognised at initial measurement. You must make a judgment call at Day 1 (Transition Date). If you decide the term is 5 years (exercising the break), you calculate the liability based on 5 years of payments. If your plans change later (e.g., at year 4 you decide to stay), you perform a Lease Remeasurement, adjusting the liability and ROU asset at that time.

Measurement: Discount Rates & Long Leases

One of the most technically challenging aspects of FRS 102 adoption is determining the appropriate discount rate. Because this single percentage drives the present value calculation of your entire lease liability, selecting the incorrect Incremental Borrowing Rate (IBR) can lead to material misstatements on the balance sheet.

Beyond the mathematics, UK finance teams must also grapple with legacy arrangements typical of the British property market, such as 999-year leaseholds and nominal 'peppercorn' rents. The following questions clarify how to derive defensible borrowing rates at the date of transition and how to account for these unique structural anomalies without overstating your obligations.

1 When transitioning to FRS 102, should the Incremental Borrowing Rate (IBR) used to discount lease liabilities be determined at the original lease inception date or at the date of transition?

At the **date of transition.** When applying the modified retrospective approach (which most entities will use), you measure the lease liability at the date of transition (e.g., 1 Jan 2026) using the remaining lease payments discounted at the lessee's incremental borrowing rate determined at that date. You do not need to go back and estimate what your borrowing rate was 5 years ago when the lease started.

2 Can an entity use its 'loss of interest' rate (investment return rate) as the discount rate for lease liabilities under FRS 102, or is the Incremental Borrowing Rate (IBR) mandatory?

No, you cannot use an investment or "loss of interest" rate. The standard requires the rate implicit in the lease. If that cannot be readily determined (which is common), you must use the lessee's Incremental Borrowing Rate (IBR) or the lessee's Obtainable Borrowing Rate (OBR).

- **IBR Definition:** The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.
- **OBR Definition:** The rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the *total undiscounted value of lease payments* to be included in the measurement of the lease liability.

3 Does FRS 102 permit the use of a portfolio discount rate (a single weighted average IBR) for a group of leases with similar characteristics (e.g., a fleet of vehicles) rather than calculating a unique rate for each lease?

Yes. As a practical expedient, FRS 102 allows you to apply a single discount rate to a portfolio of leases with reasonably similar characteristics (e.g., similar remaining lease term, similar class of underlying asset, similar economic environment). A fleet of 80 cars with similar lease terms is a perfect candidate for this simplification.

4 How do you account for a long leasehold interest under FRS 102 where a substantial premium was paid upfront and the ongoing rental payments are nominal ('peppercorn' rent)?

- **The Premium:** The large upfront payment is capitalised as part of the cost of the Right-of-Use Asset (or Property, Plant & Equipment if deemed a purchase). It is already paid, so it does not create a lease liability.
- **The Peppercorn Rent:** The Lease Liability is the present value of the future payments. If the future rent is £1/year (peppercorn), the Lease Liability is effectively zero.
- **Result:** You have a large asset on the balance sheet (from the premium) and a negligible or zero lease liability. The asset is then depreciated over its useful life.

5 How are very long-term leases (e.g., 999-year leases or 200-year leases) classified and measured under FRS 102, and does the length of the term automatically classify them as finance leases or purchases?

Extremely long leases (like 999 years) are virtually always classified as Finance Leases because the lease term covers the major part of the asset's economic life.

- **Accounting:** You recognise the asset and liability.
- **However:** If the payments are nominal (see next question), the liability may be a small amount.
- **Land vs. Buildings:** Note that land has an indefinite life, but a 999-year lease transfers substantially all risks and rewards of ownership, so it is effectively treated as a bought asset.

Measurement: Variable Payments & Incentives

Lease agreements in the UK and Ireland are rarely static, flat-fee arrangements. From rent-free incentives negotiated at inception to annual CPI-linked reviews and eventual dilapidation obligations, the cash flows associated with a lease fluctuate significantly over its life.

Under FRS 102, accurately capturing these variables requires a strict distinction between what constitutes a capitalised lease liability and what remains a period expense. This section breaks down the specific accounting mechanics for incentives, variable payments, and restoration costs, ensuring your initial measurement and subsequent remeasurements accurately reflect the economic substance of the contract.

1 How are rent-free periods or lease incentives treated in the initial measurement of the lease liability and right-of-use asset under FRS 102?

- **Lease Liability:** You calculate the liability by discounting only the payments that will actually be made. If months 1–6 are free, you input £0 for those months in your calculation. This naturally lowers the Present Value (liability).
- **ROU Asset:** The starting value of the asset is the Lease Liability plus any initial direct costs, minus any lease incentives received (like cash payments from the landlord).

2 How are variable lease payments linked to an index (e.g., CPI) or a market rate accounted for under FRS 102 at initial recognition versus subsequent measurement?

- **Initial Recognition:** You do not forecast future inflation. You calculate the liability using the index/rate as it stands at the commencement date (or transition date). If the rent is "Current Rent + CPI," you assume the CPI stays flat for the whole lease.
- **Subsequent Measurement:** When the rent actually changes (e.g., the annual review happens and rent goes up), you must remeasure the lease liability using the new cash flows. This increase typically adjusts the ROU Asset upwards, not the P&L.

3 How is a retrospective rent increase (agreed after a scheduled rent review date) accounted for under FRS 102 lease remeasurement rules?

The lease liability is remeasured when the uncertainty is resolved (i.e., when the new rent is agreed).

- You recalculate the liability using the new agreed rental amount for the remaining term.
- The difference between the old liability and new liability is adjusted against the ROU Asset.
- Any "catch-up" payment for the retrospective period is generally settled in cash and reduces the accrued liability or is expensed if it relates to a past period not provided for, though typically it's treated as part of the remeasurement adjustment.

4 Are variable lease payments based on performance or usage (such as turnover rent or percentage of sales) included in the measurement of the lease liability under FRS 102?

No. Variable payments that depend on sales, usage, or profits (turnover rent) are excluded from the lease liability.

- **Accounting:** These are recognised as an expense in the Profit & Loss account in the period they occur, exactly as they were under the old standard.
- **Hybrid Leases:** If a lease has a fixed base rent + % turnover, you capitalise the fixed base rent and expense the turnover portion.

5 Are dilapidation costs (obligations to restore the underlying asset to its original condition) included in the measurement of the lease liability or the right-of-use asset under FRS 102?

- **Lease Liability:** No. The lease liability represents the obligation to make rental payments to the lessor. Dilapidations are a separate obligation.
- **ROU Asset:** Yes. The estimated cost of dismantling/restoring the asset (dilapidations) is added to the cost of the Right-of-Use Asset.
- **The Credit Entry:** The credit side goes to a Provision for Dilapidations (under Section 21 / IAS 37), not the Lease Liability.

Transition: Timing & Short Remaining Terms

For many UK finance teams, the mandatory implementation of the updated FRS 102 feels like a distant compliance exercise. However, the critical milestone is not the filing deadline, but the Date of Initial Application—the day your opening balance sheet must be restated.

Understanding the specific cut-off points—especially for companies with the common 31 March year-end—is vital for accurate resource planning. Furthermore, the standard offers pragmatic relief mechanisms. Knowing how to apply transition expedients for leases with short remaining terms can save days of unnecessary calculation, allowing you to focus your efforts on the long-term liabilities that materially impact your gearing.

The following questions outline exactly when your obligations begin and how to leverage the available shortcuts.

1 What is the mandatory effective date for the adoption of the updated FRS 102 lease accounting standards for a company with a financial year-end of 31st March (specifically regarding years ending 2026 or 2027)?

The amendments are expected to apply to accounting periods beginning on or after 1 January 2026.

- **For a 31 March year-end:** Your first accounting period under the new rules will be the year starting 1 April 2026 and ending 31 March 2027.
- **Transition Date:** Your "date of initial application" would be the start of that period: 1 April 2026.

2 If a lease has a remaining term of less than 12 months at the date of initial application (transition date), does the lessee need to recognise a right-of-use asset and lease liability, or can it apply the short-term lease exemption?

You can apply a specific transition practical expedient. Even if the original lease was 3 years long, if the remaining term at the date of transition is less than 12 months, you can elect to treat it as a Short-Term Lease.

- **Result:** You do not capitalise it. You continue to expense the payments in the P&L for the final remaining months.

3 For a lease with only 6 months remaining at the transition date (e.g., 1 Jan 2026), is a retrospective adjustment to retained earnings required, or can the lease be expensed until expiry?

No adjustment to retained earnings is required if you use the practical expedient mentioned in the previous question. You simply ignore the capitalisation requirements and expense the remaining 6 months of rent.

- **Note:** If you choose not to use the expedient (unlikely), you would theoretically capitalise it, but the value would be immaterial and amortised fully within 6 months, making it administrative work for zero benefit.

4 When transitioning to FRS 102 midway through a 10-year lease, is the lease liability measured based on the remaining future payments from the transition date, or the original 10-year payment stream?

It is based on the remaining future payments only.

- **Liability Calculation:** You look at the payments due after the transition date (e.g., from 1 Jan 2026 to the lease end in 2031). You discount these remaining 5 years of payments to their present value at 1 Jan 2026. You do not include the 5 years of history in the liability calculation.

Measurement: Mechanics & Legacy Balances

The transition to the updated FRS 102 lease accounting raises immediate practical concerns regarding historical data: must you reopen closed financial years, and how do you reconcile legacy balances like deferred rent against the new single-model approach? Fortunately, the standard favours pragmatism over perfection, predominantly utilising the Modified Retrospective Approach to avoid the administrative burden of restating prior year comparatives.

This section details the specific accounting mechanics required at the date of initial application. From adjusting opening retained earnings to understanding why your recognised liability will always sit lower than the total cash payments due to the time value of money, these answers provide the technical blueprint for a clean, defensible transition.

1 Does FRS 102 require the restatement of comparative financial information for the prior period upon initial adoption of the lease standard?

Generally, no. Most entities will adopt the Modified Retrospective Approach. Under this approach, you do not restate the prior year's figures (comparatives). Instead, you recognise the cumulative effect of initially applying the standard as an adjustment to the opening balance of Retained Earnings at the date of initial application (e.g., 1 Jan 2026). The prior year (2025) remains exactly as it was reported under the old rules.

2 How are existing deferred rent balances or lease incentive accruals (recognised under the previous operating lease model) treated upon transition to FRS 102, and do they adjust the opening Right-of-Use asset value?

You must derecognise them. Under the modified retrospective method, the Right-of-Use (ROU) Asset is measured at an amount equal to the Lease Liability, adjusted by the amount of any prepaid or accrued lease payments.

- **The Adjustment:** If you have a Deferred Rent balance (a credit, usually from a rent-free period), you Debit the Deferred Rent to remove it, and Credit the ROU Asset.
- **Result:** This reduces the opening value of the ROU Asset. You do not write it off to P&L or Retained Earnings directly; it is absorbed into the asset valuation.

3 When a subsidiary transitions to FRS 102 using the carrying amounts determined for the consolidated group accounts (Group Carrying Value), where is the difference between the group value and the subsidiary's local legacy balances (such as prepayments) recorded?

The difference is posted to Opening Retained Earnings.

- **Scenario:** The Group provides you with an ROU Asset of £100k and Liability of £105k. Your local books still have a £2k Prepayment.
- **Mechanics:** You book the Asset (£100k) and Liability (£105k). You remove the Prepayment (£2k). The figures won't balance perfectly because the Group values likely used a different inception date/rate.
- **Plug:** The balancing figure is the "catch-up" adjustment to Opening Retained Earnings.

4 If an entity already voluntarily applies IFRS 16 for its accounts, are there significant differences or advantages to adopting FRS 102 instead?

FRS 102 is heavily aligned with IFRS 16, so the numbers will be very similar.

- **Advantage of FRS 102:** It generally requires fewer disclosures than full IFRS 16. If you are a UK entity, FRS 102 is the natural standard unless you are a listed group.
- **Advantage of Staying IFRS 16:** If you already did the work to convert to IFRS 16, switching "back" to FRS 102 might just be administrative churn. However, FRS 101 (IFRS with reduced disclosures) is often the preferred route for subsidiaries of IFRS parents.

5 In a lease calculation example, why is the recognised Lease Liability value (e.g., £94,179) lower than the total sum of the future lease payments (e.g., £108,000 or £120,000)?

The difference represents the Time Value of Money (Interest).

- **Concept:** A promise to pay £100 in five years is worth less than £100 today.
- **Calculation:** The Lease Liability is the Present Value (PV) of the future payments, discounted using the interest rate (IBR).
- **The "Gap":** The difference between the £108,000 (cash you will pay) and the £94,179 (liability today) is roughly £13,821. This amount will be recognised as Interest Expense in your P&L over the life of the lease, unwinding the discount.

Financial Impact: P&L, Tax & Banking

The adoption of the updated FRS 102 lease accounting is not merely a balance sheet exercise; it fundamentally alters the geography of your Profit & Loss account. By replacing flat rental expenses with depreciation and interest, the standard creates a "front-loaded" expense profile that can distort net profit trends and radically shift key performance metrics.

These changes ripple outwards to your external stakeholders. A sudden spike in EBITDA combined with a surge in reported debt can inadvertently trigger breaches in banking covenants or alter your tax position, particularly regarding the Corporate Interest Restriction (CIR). This section explores how to manage these optical shifts with lenders and HMRC.

1 Under FRS 102, how is the lease expense recognised in the Profit & Loss account split between depreciation and finance costs, and is this treatment identical to the traditional finance lease accounting model?

Yes, it is identical to the traditional finance lease model.

- **Depreciation:** The Right-of-Use Asset is depreciated (usually on a straight-line basis) over the lease term. This appears in Operating Expenses (but is added back for EBITDA).
- **Interest:** The Lease Liability unwinds over time, creating an Interest Expense. This appears in Finance Costs.
- **P&L Profile:** This results in a "front-loaded" expense profile—total costs are higher in the early years of the lease (high interest) and lower in later years, unlike the flat profile of the old operating lease rent.

2 Does the reclassification of operating lease payments into depreciation and interest expense under FRS 102 result in an increase in reported EBITDA?

Yes, significantly.

- **Previously:** The entire rental payment was an Operating Expense, reducing EBITDA.
- **Now:** The rental payment is split into Depreciation and Interest. Both of these are excluded from EBITDA.
- **Result:** Your Operating Profit and EBITDA will rise immediately upon transition, while your Net Profit (before tax) will likely decrease slightly in the short term due to the front-loaded interest.

3 How are UK lending institutions responding to the changes in financial ratios (specifically higher EBITDA and higher reported debt) caused by the transition to FRS 102 lease accounting in loan covenants?

Most banks are well-prepared for this.

- **Frozen GAAP:** Many loan agreements have "Frozen GAAP" clauses, meaning you calculate covenants as if the old accounting rules (FRS 102 prior to 2026) still applied.
- **Renegotiation:** If you do not have Frozen GAAP, you may breach "Debt to Equity" or "Leverage" ratios (because Debt is higher) even though "Interest Cover" might improve (because EBITDA is higher). You should open a dialogue with your lender early to reset covenant levels to reflect the "new normal."

4 Does the transition to FRS 102 lease accounting change the calculation of UK Corporation Tax and taxable profit, particularly regarding the deductibility of depreciation and interest versus rental payments?

Generally, Tax follows Accounts for leases (unless specific Capital Allowance rules apply, which is rare for standard property leases).

- **Deduction:** You typically deduct the Depreciation and Interest expense charged to the P&L, rather than the cash rent paid.
- **Timing Difference:** Because the accounting expense is front-loaded (higher interest early on), your tax deduction might be higher in early years compared to the old straight-line rent, creating a timing difference and a Deferred Tax impact.
- **Warning:** The interest portion is now subject to the Corporate Interest Restriction (CIR), which limits tax relief on interest to 30% of taxable EBITDA. This could restrict your deductions if you are a highly leveraged group.

5 How should an entity account for a Right-of-Use asset under FRS 102 if the underlying asset is no longer in use (vacated) or the lease is considered onerous?

You apply Impairment rules (Section 27).

- **The Asset:** If the asset is no longer used (e.g., a vacant office), it has no economic benefit. You must test it for impairment and likely write the ROU Asset down to its recoverable amount (which may be zero or the value of a potential sublet).
- **The Liability:** The Lease Liability remains on the balance sheet and continues to unwind.
- **Onerous Contract:** You generally do not create a separate "Onerous Lease Provision" unless the unavoidable costs exceed the economic benefits and you haven't already impaired the asset. Impairing the asset is the primary mechanism.

Execution: Practical Operations

The transition to FRS 102 lease accounting is not merely a year-end compliance exercise; it requires a fundamental redesign of your monthly close process. For operational finance teams, the challenge shifts from simply "paying the rent" to actively managing a complex liability, requiring new workflows for the Purchase Ledger and updated journal protocols.

This section tackles the mechanics of implementation: from coding journal entries without disrupting your Accounts Payable team to justifying the administrative effort required to make the shift to FRS 102 lease accounting. Crucially, we also explore how to leverage these changes to demonstrate strategic value—specifically, how the technical shift to EBITDA-based reporting can materially enhance business valuation and exit readiness.

1 What is the correct journal entry coding for a monthly rent invoice received from a vendor under FRS 102, considering the split between lease liability reduction and interest expense?

There are two common methods.

» **Method A (Direct):** Code the invoice directly to the Lease Liability account (Balance Sheet) instead of "Rent Expense" (P&L). You then post a separate journal to recognise the Interest Expense (Dr Interest, Cr Lease Liability) to accrue the time value of money.

» **Method B (Reversal - Preferred for AP Teams):** Let the AP team code the invoice to "Rent Expense" as usual. Then, post a recurring monthly journal that:

1. Credits Rent Expense (to remove it).
2. Debits Depreciation (Operating Expense).
3. Debits Interest Expense (Finance Cost). This is often easier than training AP staff on liability accounts.

2 Is it permissible under FRS 102 to post lease accounting journal entries (depreciation and interest) on an annual basis rather than monthly, particularly for subsidiaries aligning with a parent company's reporting cycle?

Yes, provided you only issue external financial statements annually.

» **Compliance:** FRS 102 does not mandate monthly bookkeeping, only that the financial statements at the reporting date are correct.

» **Risk:** If you produce monthly management accounts, posting annually will distort your monthly results (showing huge profits in months 1-11 and a large adjustment in month 12). For accurate management reporting, monthly journals are strongly recommended.

3 What are the key commercial benefits or strategic arguments to present to SME management teams to justify the administrative effort required for the transition to FRS 102 lease accounting?

» **Improved EBITDA:** This is the biggest selling point. Moving rent to "Interest & Depreciation" instantly boosts EBITDA, a key metric for bank covenants and business valuation.

» **Exit Readiness:** If the owner plans to sell, buyers will scrutinise off-balance sheet liabilities. Having them recognised and clean makes due diligence faster and increases buyer confidence.

» **Better Decision Making:** It forces the business to actually track lease expirations and costs accurately, preventing "accidental" rollovers of unwanted equipment or property leases.

Summary: Moving From Manual Calculation to Strategic Compliance

As these questions demonstrate, the transition to the updated FRS 102 is not merely a "check-the-box" exercise; it is a fundamental change to how your business measures and reports its obligations. The complexity of determining lease terms, managing break clauses, and calculating Present Value (PV) for hundreds of assets introduces a significant risk of error if managed manually.

Attempting to handle these calculations in spreadsheets creates a fragile compliance environment. A broken formula, a missed rent review, or an incorrect discount rate can lead to a stressful month-end close, audit deficiencies, or even material misstatements.

FinQuery simplifies this complexity. Our platform is purpose-built to handle the rigours of FRS 102 and IFRS 16 lease accounting. FinQuery centralises your lease data into a **Unified Subledger** and automates the difficult calculations—from the initial recognition of the ROU asset to complex remeasurements caused by modifications. We transform a high-risk compliance burden into a structured, auditable process, giving you the peace of mind that your balance sheet is accurate and your team is ready for the auditors.